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The Assistant Secretary of the Navy

(FINANCIAL MANAGEMENT AND COMPTROLLER)

1000 NAVY PENTAGON

WASHINGTON, D.C. 20350-1000



November 2004

I am pleased to present the Department of the Navy's Fiscal Year 2004 Annual Financial Report. Improvements in the Department's stewardship of public resources are reflected in this year's report.

As the Department of the Navy continues to provide Congress and the public with relevant, reliable, and timely financial information, and strives for favorable audit opinions, accountability becomes even more important as we prosecute the Global War on Terrorism and support the nation's defense needs. The Department's Financial Improvement Plan will help us achieve our goal.

The Financial Improvement Plan identifies actions and timeframes for correcting financial management deficiencies in the Department and will result in further improvements in the Principal Statements and notes presented in this Annual Financial Report. Measurements of success have also been built into this plan. Our financial improvement efforts focus on maintaining a highly skilled workforce; standardizing and transforming business processes; and maintaining and aligning systems with the Department of Defense Business Management Modernization Program. This effort must and will succeed.

I am proud of the Department of the Navy's progress thus far, and the enthusiasm exhibited by all communities that support the business processes that provide our war fighters with the resources and financial intelligence to succeed. We must sustain this momentum, leverage lessons learned, and move forward with transformational initiatives.

A handwritten signature in dark ink, appearing to read "R. Panek".

Robert L. Panek

Acting



DEPARTMENT OF THE NAVY

MANAGEMENT'S DISCUSSION AND ANALYSIS



“The very best organizations are the most efficient organizations.”

-- The Honorable Gordon R. England, Secretary of the Navy, March 2004

INTRODUCTION

The Department of the Navy (DON) is one of the most visible organizations in the world. With service members and civilian employees in geographically dispersed locations, the spotlight on our contributions and our sacrifices never dims. The contributions and sacrifices of our Navy-Marine Corps Team in prosecuting the Global War on Terrorism have been significant to the overall success of U.S. military forces. As a Nation, we are blessed to have a 228-year legacy where magnificent men and women volunteer as Sailors and Marines to protect and defend America. The contributions and sacrifices of our civilian workforce have been instrumental in supporting our Navy-Marine Corps Team. These experienced and dedicated craftspeople, researchers, supply and maintenance specialists, computer experts, service providers, and their managers are an essential part of our total naval force concept.

As we continue to prosecute the Global War on Terrorism, DON remains focused on improving effectiveness to gain efficiency, facilitating our transformation in force management, combat and technological capabilities, and business management. The discussion that follows focuses on our achievements in each area of the DON Balanced Scorecard: People, Combat Capability, Technology Insertion, and Improved Business Practices.

OUR PEOPLE

The Department of the Navy (DON) remains committed to taking care of its people. As reflected in the Secretary of the Navy's priority objectives for fiscal year (FY) 2004, DON is pursuing a strategy that enhances the quality of service and life of our Sailors and Marines and that shapes and streamlines our military and civilian workforce. Below is a synopsis of our achievements in the areas of Quality of Service, Quality of Life, and Human Resource Management.

“Sailors and Marines - along with our civilian workforce - remain the strong and steady foundation of our Naval capabilities.”

-- The Honorable Gordon R. England,
Secretary of the Navy, March 2004

QUALITY OF SERVICE

UNITED STATES NAVY	UNITED STATES MARINE CORPS
<p>The Navy shall be organized, trained, and equipped primarily for prompt and sustained combat incident to operations at sea. It is responsible for the preparation of naval forces necessary for the effective prosecution of war except as otherwise assigned and, in accordance with integrated joint mobilization plans, for the peacetime components of the Navy to meet the needs of war.</p> <p><i>(Section 5062, Title 10, U.S. Code)</i> Founded 13 October 1775</p>	<p>The Marine Corps shall be organized, trained, and equipped to provide fleet marine forces of combined arms, together with supporting air components, for service with the fleet in the seizure or defense of advanced naval bases and for the conduct of such land operations as may be essential to the prosecution of a naval campaign.</p> <p><i>(Section 5063, Title 10, U.S. Code)</i> Founded 10 November 1775</p>



Sailing into New York Harbor, Sailors and Marines “man the rails” aboard the USS IWO JIMA (LHD 7).

DON developed a Training Resource Strategy to provide high quality training to its deploying combat forces. The training of high technology forces in modern warfare has shifted to a stateside network of existing ranges and installations. Fully implemented, the Training Resource Strategy has resulted in more training options, reduced pre-deployment training transit time, and has increased productive training days. The USS ENTERPRISE was the first Carrier Strike Group to deploy under the Training Resource Strategy, utilizing six training ranges. The Training Resource Strategy supports the Fleet Response Plan and will be used to respond quickly to surge requirements by delivering and bringing to bear a capable fighting force. (A discussion of the Fleet Response Plan follows in the next section, "Our Combat Capability.")

In January 2004, DON participated in the first in a series of Joint National Training Capability exercises. These exercises linked a Marine Corps Combined Arms Exercise with live Close Air Support sorties, a Navy Stand-off Land Attack Missile Exercise, an Army rotation at the National Training Center, and an Air Force Air Warrior Exercise. The Marine Corps will be actively involved in future Joint National Training Capability exercises, including Combined Arms Exercises, Marine Aviation Weapons, and Tactics Squadron-1 evolution's scheduled for FY 2005.

QUALITY OF LIFE

DON works to improve the quality of life for Sailors and Marines and their families in order to continue the success of the all volunteer force. Quality of life programs and services available to service members and their families include the Fleet and Family Support Center and Marine Corps Community Services OneSource. The Fleet and Family Support Center provides free operational, mobility and counseling support to all service members, single or married, including activated Reservists, retiree's and Department of Defense (DoD)

civilians overseas. The Center has enhanced delivery of services by dispatching Return and Reunion teams to sea and adding online features such as the DoD's new Navy OneSource information and referral system. Similarly, the Marine Corps implemented Marine Corps Community Services OneSource, a DoD-funded pilot program that provides around-the-clock information and referral services to Marines and their families before, during, and after deployments. Marine Corps Community Services OneSource is especially useful to activated Marine Reserves and their families as they negotiate the requirements and procedures associated with utilization of military programs such as TRICARE and other benefit services.

Additionally, DON remains committed to improving living conditions for Sailors and Marines, and their families. With an increased emphasis on public-private ventures and an increase in Basic Allowance for Housing, DON remains on track to eliminate inadequate housing by FY 2007.

HUMAN RESOURCE MANAGEMENT

DON has made several fleet and shore organizational changes that have shown great potential in maximizing the way forces can be employed and supported. One of these changes is alignment of Navy shore installations under a single Major Command - Commander, Navy Installations. This alignment will enable DON to implement common support practices and make better decisions about where to invest limited funds.

Additionally, DON is restructuring its active and reserve forces under the Active Reserve Integration initiative. This initiative will fully integrate the naval reserve force with the active force in an effort to create a more cohesive, surge-ready force. This "one fleet" perspective is the most effective, efficient use of resources because it matches capabilities with requirements for optimum performance. DON expects the realization of Active Reserve Integration to result in increased warfighting wholeness for the current Navy-Marine Corps Team and the team of the next generation.

The FY 2004 National Defense Authorization Act authorized DoD to establish a new human resources management system for DoD civilians known as the National Security Personnel System. This legislation provides flexibility in the hiring and management of civilian workers and links pay to mission accomplishment and performance. The National Security Personnel System will be implemented over a three-year period. DON will participate in the first pilot scheduled to commence at fiscal year-end 2005.



US Marines assigned to the 22nd Marine Expeditionary Unit, Special Operations Capable, conduct physical training on the flight deck of the USS WASP (LHD 1).

OUR COMBAT CAPABILITY

"Innovative capabilities will result in profound increases in military power, maintaining the Navy and Marine Corps Team as the preeminent global Naval power."

-- The Honorable Gordon R. England, Secretary of the Navy, March 2004

The Department of the Navy (DON) has embraced a transformational, capabilities-based approach to forming the Navy-Marine Corps Team of tomorrow. Two transformational initiatives underway are the Fleet Response Plan and Tactical Aircraft Integration.

FLEET RESPONSE PLAN

The Fleet Response Plan, implemented in fiscal year (FY) 2004, represents a new paradigm in force readiness. Under the old paradigm, the Navy sought to achieve the highest levels of readiness for forward-deployed units. While a number of forward-deployed units were at peak readiness, the majority of ships and associated units were not deployed and thus at a point in their Inter-Deployment Readiness Cycle that made it difficult and expensive to meet the rapid surge requirements of a crisis, conflict, or Homeland Defense mission. In contrast, under the Fleet Response Plan, the Navy's goal is to develop and sustain significant, surge-ready combat capabilities through the use of Carrier Strike Groups, Expeditionary Strike Groups, and Surface Strike Groups. Under the "six-plus-two" concept, the Navy will organize and sustain six Carrier Strike Groups capable of deploying within 30 days to support global contingency operations; and an additional two Carrier Strike Groups ready to deploy within 90 days to reinforce or rotate with forces, continue presence operations in other parts of the world, or support military action in other crises. Overall, the Fleet Response Plan provides a framework in which the Navy can balance unprecedented combat capability and readiness with the prudent use of resources.

"Summer Pulse '04"

"Summer Pulse '04" was the Navy's first test of the Fleet Response Plan. During July and August 2004, seven Carrier Strike Groups successfully deployed and operated in five theaters with other U.S. allied and coalition forces. The near-simultaneous deployment of these Carrier Strike Groups provided the Navy and the Joint Combatant Commanders an opportunity to exercise the Fleet Response Plan while maintaining the ability to respond to crises around the globe, enhance regional security and relationships, meet Combatant Commander requirements (including forward presence), and demonstrate a commitment to allies and coalition partners. The success of this exercise reflects the effectiveness and efficiencies associated with DON's investment in readiness and improved productivity.



Signalman communicates with the guided missile destroyer USS CURTIS WILBER (DDG 54) in the Kitty Hawk Carrier Strike Group in Summer Pulse 2004.

TACTICAL AIRCRAFT INTEGRATION

DON continues to implement the Tactical Aircraft Integration plan to create a leaner, more efficient naval strike-fighter force. Success factors of this plan include global sourcing and level readiness. Global sourcing is the ability to task any non-deployed DON squadron to either Navy's or Marine Corps' missions, allowing for a reduction in force structure. Level readiness is the ability to apply the proper resources to training, maintenance, and modernization, ensuring that the smaller force is always capable of responding to the needs of the Navy-Marine Corps Team and the nation. Additionally, support of readiness accounts, modernization programs, and replacement of the F/A-18 and AV-8B with the Short Takeoff and Vertical Landing Joint Strike Fighter will ensure the potential promised by this integration. Overall, Tactical Aircraft Integration retains the Navy-Marine Corps Team's warfighting potential and brings DON a step closer to the flexible sea-based force envisioned for the future.

OUR TECHNOLOGY INSERTION

"...our Naval forces have been able to project overwhelming combat power because they are technologically superior. We continue to sustain a robust RDT&E effort as we transform the Navy and Marine Corps to the next generation of combat systems."

-- The Honorable Gordon R. England, Secretary of the Navy, March 2004

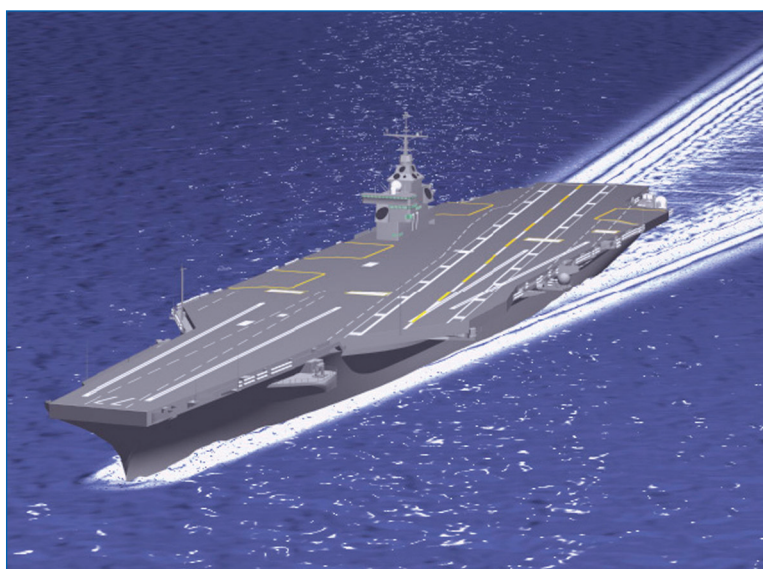
The transformation of our naval forces through innovative operational concepts and the application of appropriate technologies leverage our enduring capabilities for projecting sustainable, immediately deployable, joint combat power. Two focal areas for naval technological transformation include ship programs and Marine Corps aviation and ground equipment, as discussed below. These focal areas are representative examples of naval technological transformation and therefore are part of a broader list of naval transformation priorities.

SHIP PROGRAMS

The Department of the Navy (DON) continues to address the requirement for the acquisition, modernization, and recapitalization of the world's preeminent surface fleet. Continuing to integrate emerging technologies, DON will ensure that tomorrow's fleet will remain on the cutting edge. Two of DON's transformational surface programs include the CVN-21 and the Littoral Combat Ship.

CVN-21

CVN-21 will be a transformational 21st century ship and the future centerpiece of the Carrier Strike Group. It will have a new electrical generation and distribution system, an electro-magnetic aircraft launching system, a new and enlarged flight deck, weapons and material handling improvements, and a smaller crew.



Artist's conception of the CVN-21.

Littoral Combat Ship

The Littoral Combat Ship is a new breed of U.S. Navy warship that will be a critical component of tomorrow's Carrier Strike Groups and Expeditionary Strike Groups. The Navy envisions this ship to be a fast, agile, and affordable surface combatant capable of operating against anti-access, asymmetric threats in littoral (i.e., the transition areas between the sea and land). The Navy plans detailed design and construction of the first Littoral Combat Ship in FY 2005.

MARINE CORPS AVIATION AND GROUND EQUIPMENT

The Marine Corps is committed to transforming tactical and operational capabilities that will provide a critical joint competency for assuring access and projecting naval power. Representative examples of new systems

that will enhance the already potent combat power of the Marine Air Ground Task Force are the MV-22 Osprey, Short Take Off and Vertical Landing Joint Strike Fighter, and Expeditionary Fighting Vehicle.

MV-22 Osprey

The MV-22 Osprey remains a priority among Marine Corps aviation acquisitions. While fulfilling the critical Marine Corps medium lift requirement, the MV-22 Osprey's increased range, speed, payload, and survivability will generate truly transformational tactical and operational capabilities. The MV-22 Osprey will replace the Marine Corps' aging fleets of CH-46E Sea Knight and CH-53D Sea Stallion helicopters.

Short Take Off and Vertical Landing Joint Strike Fighter

The Short Take Off and Vertical Landing Joint Strike Fighter will be a single engine, stealth, supersonic aircraft, designed to replace the aging Marine Corps' AV-8B and F/A-18 fleets. This strike-fighter will combine the basing flexibility of the AV-8B with the multi-role capabilities, speed, and maneuverability of the F/A-18 to fulfill both the air-to-ground and air-to-air requirements of the Marine Corps.



Members of 3rd Battalion, 3rd Marine Regiment, Combat Assault Company advance to offensive positions during exercise Rim of the Pacific (RIMPAC) 2004.

Expeditionary Fighting Vehicle

The Expeditionary Fighting Vehicle will provide Marine Corps surface assault elements the requisite operational and tactical mobility to exploit fleeting opportunities in the fluid operational environment of the future. Designed to be off-loaded by ships located beyond the enemy's visual horizon, the Expeditionary Fighting Vehicle will be capable of carrying a Marine rifle squad at speeds in excess of 20 nautical miles per hour even in rough seas. Production representative vehicle procurement occurred in FY 2003 and will deliver in FY 2005. Initial operational capability will be reached in FY 2008.



A Lighter Amphibious Resupply Cargo (LARC) checks the water level prior to the disembarking members of 3rd Battalion, 3rd Marine Regiment, Combat Assault Company.

OUR IMPROVED BUSINESS PRACTICES

"[Our] continuous improvement initiatives enable us to increase our combat capabilities with the expectation that we become more efficient...at a reduced cost of doing business."

-- The Honorable Gordon R. England, Secretary of the Navy, March 2004

The breadth of our financial resources requires a steadfast commitment to fiscal accountability and to incorporating efficient and effective business practices throughout the Department of the Navy (DON). To illustrate the relative scope of our financial resources, DON would rank among the 15 largest U.S. corporations on the Fortune 500™ list for total assets. In fiscal year (FY) 2004, DON reported total assets of \$321 billion (i.e., combined total dollars of FY 2004 DON General Fund and Navy Working Capital Fund assets). (See FY 2004 DON General Fund and Navy Working Capital Fund consolidated balance sheets in this report.) The following are a few examples of our commitment to improving business and financial management throughout DON.

DON FINANCIAL IMPROVEMENT PROGRAM

DON is finalizing development of a Financial Improvement Program that supports DON and Department of Defense (DoD) goals to produce relevant, reliable, and timely financial information. The cornerstone of this program is the DON Financial Improvement Plan (formerly, the Mid-Range Financial Improvement Plan). DON is continuously refining the plan to incorporate executable tasks and timeframes for correcting deficiencies in DON General Fund and Navy Working Capital Fund financial statement line



The golden anchor is proudly displayed by the guided missile cruiser USS LAKE ERIE (CG 70) and reflects the ship's high retention rate.

items. This plan, as well as the financial improvement plans of the other Services, will be used to facilitate progress toward a favorable audit opinion on the FY 2007 DoD-wide financial statements.

Similarly, DON has established an audit committee that will interface with the federal and private sector audit communities to ensure that DON financial statements are ready for audit. Additionally, DON is coordinating its financial improvement efforts with the DoD Business Modernization and Systems Integration office – the program management office for the DoD Business Management Modernization Program. This coordination ensures DON compliance with business process and system requirements established and maintained under this DoD program.

Global Combat Support System-Marine Corps

The Global Combat Support System-Marine Corps is part of the Global Combat Support System (GCSS), a DoD - sponsored information technology program, designed to streamline DoD logistics and combat service support processes. GCSS-Marine Corps will be based upon a logistics operational architecture that will facilitate integration of current Marine Corps supply, logistics, distribution, and financial processes. Integration of these processes will enable data and information to be shared across the Marine Corps enterprise and with other Services and agencies. Components of this architecture include, but are not limited to:

- A web-based portal that provides a single point of entry for product and service acquisitions, and
- A logistics functionality that supports Marine Air Ground Task Force command and control (C2) processes.

Initial operational capability of the GCSS-Marine Corps is scheduled for FY 2005.



The Los Angeles-class attack submarine USS HAMPTON (SSN 767) surfaces at the North Pole.

CONVERGENCE OF ENTERPRISE RESOURCE PLANNING PILOTS

In FY 2004, the Navy component of DON continued to successfully operate four Enterprise Resource Planning (ERP) system pilots – a financial management initiative to streamline Navy business processes. These Navy ERP system pilots are:

- SIGMA (Program Management under the DON General Fund and Navy Working Capital Fund);
- CABRILLO (Warfare Center Management under the Navy Working Capital Fund only);
- SMART (Aviation Supply and Maintenance under the DON General Fund and Navy Working Capital Fund); and
- NEMAIS (Regional Ship Maintenance under the DON General Fund and Navy Working Capital Fund).

These system pilots use commercial off-the-shelf software approved and certified by the Joint Financial Management Improvement Program. Additionally, under the auspices of the converged ERP program office, the Navy component of DON

continued efforts to collapse these ERP system pilots into one solution. The Converged ERP Program will be the key enabler for Sea Enterprise, the flagship effort for transforming required business processes and generating enterprise-wide efficiency savings to support the planned recapitalization of naval forces. Benefits of the converged ERP system include, but are not limited to:

- Improved logistics ashore and afloat, thereby increasing fleet combat readiness;
- End-to-end supply chain integration; and
- Cost reductions and improved performance of business operations for acquisition, budget, procurement, workforce management, and decision-making.

Initial operational capability of the converged ERP system is planned for the third quarter of FY 2006.



A sailor from the guided missile destroyer USS ROSS (DDG 71) throws a line to the pier.

STRATEGIC MANAGEMENT

INTRODUCTION

The Department of the Navy (DON) remains committed to accomplishing its mission in a way that delivers the best value to the Nation and reflects accountability for results. To this end, DON has consolidated the objectives and performance management goals of the President's Management Agenda with the four tenets of Department of Defense (DoD) risk management – Force Management Risk, Operational Risk, Future Challenges Risk, and Institutional Risk – to form a balanced scorecard for risk management. These four tenets of risk management align with the four perspectives of the DON Balanced Scorecard – People, Combat Capability, Technology Insertion, and Improved Business Practices. This alignment provides DON with an efficient approach to measuring, evaluating, and improving strategic performance consistent with the goals of defense policy and the President's Management Agenda. (A copy of the President's Management Agenda and the Quadrennial Defense Review, which includes a discussion of the four DoD risk tenets, is available at the respective websites of the Office of Management and Budget (<http://www.whitehouse.gov/omb>) and DefenseLink (<http://www.defenselink.mil>)).

Mission of the Department of the Navy:

- Control and maintain freedom of the seas
- Project power beyond the sea
- Influence events and advance U.S. interests across the full spectrum of military operations



U.S. Marines assigned to Combat Service Support Group Three, role play, as opposition forces observe amphibious assault vehicles deploying from amphibious dock landing ship USS RUSHMORE (LSD 47), during the operational phase of exercise Rim of the Pacific 2004.

PERFORMANCE RESULTS: FY 2004 v. FY 2003

The DON strategic goals and related performance results shown below are representative examples from the balanced scorecard for risk management. To view this balanced scorecard in its entirety, see the website of the Assistant Secretary of the Navy (Financial Management and Comptroller), Office of Budget (<http://navweb.secnav.navy.mil>).

FORCE MANAGEMENT RISK

Strategic Goal 1: Ensure Sustainable Military Tempo

DON must be able to provide and maintain ready forces necessary to support military operations at any tempo. In FY 2004, DON sustained a force structure necessary to meet deployment requirements of the Global War on Terrorism and other military operations. As displayed in the table below, total military end strength (i.e., combined total of Navy and Marine Corps, active and reserve) decreased by two percent during FY 2004.

Strategic Goal 2: Maintain Reasonable Force Costs

DON continues to strive toward a leaner, more efficient organization so that it can best address its warfighting and recapitalization requirements. One way DON strives to improve operational efficiency is workforce reduction. In FY 2004, DON reduced civilian full-time equivalent workyears (i.e., how DON tracks the civilian workforce) by approximately one percent. (See table below)

Force Management Risk			
DON Strategic Goal	Performance Measure	Performance Results	
		FY 2004	FY 2003 *
Ensure Sustainable Military Tempo	Military End Strength		
	Active, Navy	373,800	382,235
	Active, Marine Corps	175,000	177,779
	Reserve, Navy	85,900	88,156
	Reserve, Marine Corps	39,600	41,046
Maintain Reasonable Force Costs	Civilian Full-Time Equivalent Workyears		
	Navy	179,935	180,032
	Marine Corps	16,878	17,921

*Results derived from FY 2005 President's Budget.

OPERATIONAL RISK

Strategic Goal 1: Ensure Force Levels

Projecting power from the sea is critical to the security of the United States and its interests abroad. DON remains focused on the Navy-Marine Corps Team's ability to fulfill deployment requirements for U.S. and related international defense missions. In FY 2004, the total number of battle force ships and Marine Corps land forces decreased by nearly two and three percent, respectively (see table below).

Strategic Goal 2: Ensure Force Readiness

The Global War on Terrorism requires that naval forces operate differently, to be more ready and responsive. The Fleet Response Plan has been designed to accomplish these objectives. As displayed in the table below, the number of Navy and Marine Corps personnel on deployment decreased by approximately two percent in FY 2004. However, modifications in readiness thresholds resulted in a 12 percent decrease in monthly flying hours of active crew, and a 24 percent decrease in steaming days per quarter for active force ships.

Operational Risk			
DON Strategic Goal	Performance Measure	Performance Results	
		FY 2004	FY 2003 *
Ensure Force Levels	Battle Force Ships		
	Aircraft Carriers	12	12
	Fleet Ballistic Missile Submarines	14	16
	Guided Missile Submarines	4	2
	Surface Combatants	103	106
	Nuclear Attack Submarines	53	54
	Amphibious Warfare Ships	35	36
	Combat Logistics Ships	34	34
	Mine Warfare Ships	17	17
	Support Ships	19	19
	Number of Marine Corps Land Forces		
	Marine Expeditionary Forces	3	3
	Marine Expeditionary Brigades	4	4
	Battalions	69	72
Ensure Force Readiness	Navy / Marine Corps Personnel Readiness Ratings	38,015	38,655
	Monthly Flying Hours Per Crew Ratio (Active)	19.3	22.1
	Active Steaming Days Per Quarter	51.0	67.3

*Results derived from FY 2005 President's Budget.

FUTURE CHALLENGES RISK

Strategic Goal: Define and Develop Transformational Capabilities

DON remains focused on naval transformational capabilities. A key component of naval transformation is research and development. Representative examples of research and development platforms include:

- Joint Strike Fighter - a family of aircraft that meets the needs of the U.S. Navy, U.S. Marine Corps, U.S. Air Force, and allies.
- DD(X) - a family of advanced multi-mission warships capable of long-range firepower in support of forces ashore.
- V-22 - a joint aircraft program designed to meet the amphibious/vertical assault needs of the Marine Corps and the strike rescue needs of the Navy, and to supplement special mission aircraft.

The table below presents FY 2003 and FY 2004 funding for these research and development platforms.

Future Challenges Risk			
DON Strategic Goal	Performance Measure	Performance Results	
		FY 2004	FY 2003 *
Define and Develop Transformational Capabilities	Major Platform Research and Development		
	Joint Strike Fighter	\$2,091M	\$1,662M
	DD(X)	\$1,025M	\$ 668M
	V-22	\$ 367M	\$ 387M

**Results derived from FY 2005 President's Budget.*



Marines, assigned to 3rd Battalion, 3rd Marine Regiment, approach a landing zone for extraction.

INSTITUTIONAL RISK

Strategic Goal 1: Streamline Decision Processes, Drive Financial Management and Acquisition Excellence

This strategic goal distills the business transformation initiative underway in DoD. DON remains committed to business transformation, as exemplified by its information technology initiative, the Navy Marine Corps Intranet (NMCI), and its financial management initiative, the Enterprise Resource Planning system pilots. The table below presents FY 2003 and FY 2004 comparative data for the number of NMCI seats cutover, and the reduction of applications from implementation of the Enterprise Resource Planning system pilots. The number of NMCI seats cutover (i.e., installed on a user's desk top) is cumulative. Therefore, 201,270 seats have been cutover as of FY 2004 representing increased connectivity to NMCI throughout DON. The number of applications reduced through implementation of the Enterprise Resource Planning system pilots remain unchanged in FY 2004.

Strategic Goal 2: Improve Readiness and Quality of Key Facilities

Among key facilities slated for improvement are housing units for Sailors and Marines, and their families. With an increased emphasis on public-private ventures, DON remains on track to eliminate inadequate housing by FY 2007. (See table below)

Institutional Risk			
DON Strategic Goal	Performance Measure	Performance Results	
		FY 2004	FY 2003 *
Streamline Decision Processes, Drive Financial Management and Acquisition Excellence	Number of Navy Marine Corps Intranet Seats Cut Over	201,270	109,602
	Implement Enterprise Resource Planning - Number of Applications Reduced	70	70
Improve Readiness and Quality of Key Facilities	Number of Privatization Projects/Units	3,493	9,549

**Results derived from FY 2005 President's Budget.*

MANAGEMENT INTEGRITY

Commanders and managers throughout the Department of the Navy (DON) must ensure the integrity of their programs and operations. Part of this responsibility entails compliance with applicable laws and regulations. Two applicable statutes include the Federal Managers' Financial Integrity Act of 1982 and the Improper Payments Information Act of 2002. Under this statute, DON must present improper payments information in the annual report, beginning with fiscal year (FY) 2004. A discussion of both statutes and their applicability to DON appears below.

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT OF 1982

As required by implementing guidance from the Office of Management and Budget and the Department of Defense, under the Federal Managers' Financial Integrity Act of 1982, DON must evaluate its system of internal accounting and administrative controls (i.e., management controls) on an annual basis. The objective of this evaluation is to determine whether reasonable assurance exists that:

- obligations and costs are in compliance with applicable laws;
- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
- revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of reliable accounting, financial, and statistical reports and to maintain accountability over assets.



A Marine secures razor wire while setting up camp during Exercise Bearing Duel '04.

For FY 2004, DON issued a qualified statement of assurance, citing material weaknesses in management controls. Specifically, DON's system of internal accounting and administrative controls in effect during the 12-month period ending June 30, 2004, taken as a whole, provides reasonable assurance that DON can execute its mission effectively and protect its critical assets, with the exception of material weaknesses reported. The basis for reasonable assurance includes an established control environment, continued emphasis on risk assessment, specific control activities, continuous communication and flow of information, and monitoring performed by both command management and the audit/inspection community. Additionally, the effective execution of missions during recent military actions confirms the strength of DON's management controls. To view the FY 2004 statement of assurance in its entirety, see the website for the Assistant Secretary of the Navy (Financial Management and Comptroller), Office of Financial Operations (http://www.fmo.navy.mil/MCP/soa_index.htm).

IMPROPER PAYMENTS INFORMATION ACT OF 2002

A component of the President's Management Agenda is the initiative to reduce improper payments. Improper payments are those which should not have been made or that were made in incorrect amounts under statutory, contractual, administrative, or other legally applicable requirements. Examples of improper payments include overpayments, underpayments, duplicate payments, and payments for services not received.

DON programs and activities susceptible to erroneous payments are those for which DON has the responsibility for entitlement computation and/or disbursement of government funds. Examples include DON Personnel Support Activities and Detachment, which are responsible for the entitlement computation for some travel payments; and DON Disbursing Officers aboard ships and at other isolated locations, which are responsible for disbursement of government funds. Note that the Defense Finance and Accounting Service provides the vast majority of DON's entitlement computation and disbursement functions.

As required by implementing guidance from the Office of Management and Budget under the Improper Payments Information Act of 2002, DON identified \$700 thousand of improper payments in FY 2004. This amount is significantly less than the Office of Management and Budget threshold of \$10 million. Consequently, for the programs for which DON has entitlement computation and/or disbursement responsibility, we have instituted internal controls designed to mitigate the occurrence of improper payments in future fiscal years.



REPORTING RESULTS

For financial reporting purposes, the Department of the Navy (DON) is organized into two reporting entities: DON General Fund and Navy Working Capital Fund. Each entity has its own set of financial statements and related notes (see Principal Statements and Notes in this report). In terms of assets, the General Fund accounts for 92 percent and the Navy Working Capital Fund accounts for 8 percent of DON fiscal year (FY) 2004 Total Assets. DON has been producing DON General Fund financial statements since FY 1996, and Navy Working Capital Fund financial statements since FY 1991. Below is a discussion of each entity, including FY 2004 performance.

DON GENERAL FUND

The DON General Fund supports overall Department operations. Direct appropriations from Congress comprise the DON General Fund account structure. Examples of DON General Fund appropriation types are:

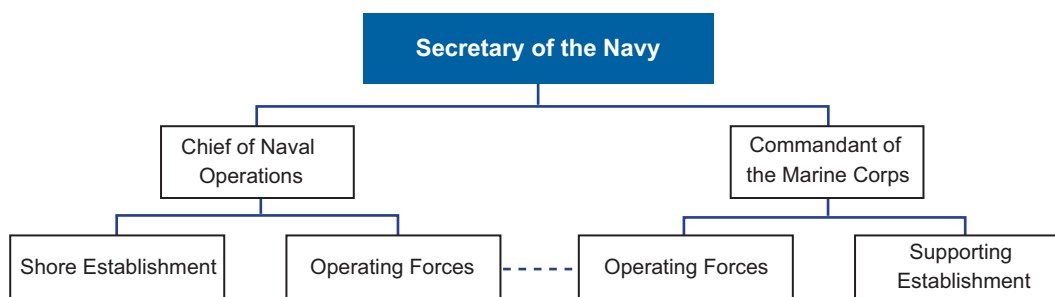
- Military Personnel;
- Operation and Maintenance;
- Procurement;
- Research, Development, Test and Evaluation;
- Military Construction; and
- Family Housing.

For a complete list of DON General Fund appropriations, see "General Fund Other Accompanying Information" in this report.

MAJOR COMMANDS

DON is comprised a joint warfighting team: U.S. Navy and U.S. Marine Corps. Both services have numerous major commands that operate under the authority and responsibility of a Commander or other designated official who has similar authority and responsibility. Each major command has a defined mission that supports the overall DON mission and generally supports a network of subordinate commands.

For purposes of our discussion, Navy major commands can be grouped into three categories: Secretariat, Shore Establishment, and Operating Forces. The Shore Establishment and Operating Forces operate under the purview of the Chief of Naval Operations. Similarly, the Supporting Establishment and Operating Forces of the Marine Corps organization operate under the purview of the Commandant of the Marine Corps. See organization chart on page 28. (To view the DON organization in its entirety, see the respective Navy and Marine Corps websites (<http://www.navy.mil> and <http://www.usmc.mil>.)



Due to the breadth of the DON organization and space limitations of this report, we have included representative examples of Navy major commands below. Included with these examples are the mission and end strength of each Navy major command. Mission and end strength of the Marine Corps follow in the next section, "Marine Corps Organization."

SECRETARIAT

Assistant for Administration to the Under Secretary of the Navy

Mission: To provide timely and responsive management and customer services to the Secretariat, staff offices, field activities, and supported organizations in order to enable them to effectively execute goals.

FY 2004 End Strength:

Military personnel: 990

Civilian personnel: 4,255

Office of Naval Research

(Office of Naval Research operates under the Chief of Naval Research, Assistant Secretary of the Navy (Research, Development, and Acquisition).)

Mission: To coordinate, execute, and promote science and technology programs of the U.S. Navy and Marine Corps through schools, universities, government laboratories, and nonprofit and for-profit organizations; to provide technical advice to the Chief of Naval Operations and the Secretary of the Navy; and work with industry to improve technology manufacturing processes.

FY 2004 End Strength:

Military personnel: 18

Civilian personnel: 2,937

OPERATING FORCES

Commander, U.S. Fleet Forces

(Commander, U.S. Fleet Forces has dual responsibility as Commander, U.S. Atlantic Fleet.)

Mission: To fully organize, train, maintain, equip, and man active and reserve naval forces in support of the Unified Command Plan; develop and articulate authoritative Fleet-coordinated readiness and warfighting requirements; establish and implement Fleet-coordinated and integrated standards and policies for Fleet units; execute assigned readiness and personnel accounts to develop required levels of Fleet readiness; and explore transformational concepts.

FY 2004 End Strength:

Military personnel: 126,621

Civilian personnel: 7,085

Commander, U.S. Pacific Fleet

Mission: To support the U.S. Pacific Command's theater strategy, and to provide interoperable, trained and combat-ready naval forces to the U.S. Pacific Command and other U.S. Unified Commanders.

FY 2004 End Strength:

Military personnel: 106,925

Civilian personnel: 18,597

Commander, U.S. Naval Forces Europe

Mission: To execute missions assigned by Commander U.S. European Command, and perform U.S. Navy functions assigned by the Chief of Naval Operations; maintain and employ ready forces to conduct the full range of military operations unilaterally or in concert with coalition partners; enhance trans-Atlantic security through support of the North Atlantic Treaty Organization; promote regional stability; counter terrorism; and enhance U.S. interests in the European theater.

FY 2004 End Strength:

Military personnel: 1,924

Civilian personnel: 171

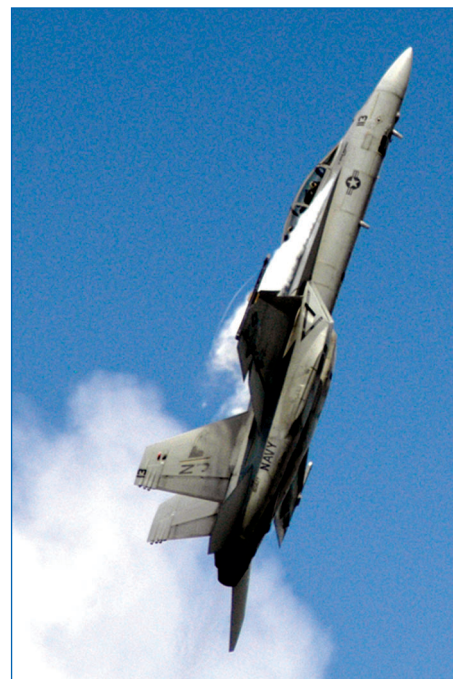
Commander, Naval Reserve Force

Mission: To provide mission-capable units and individuals to the Navy-Marine Corps Team throughout the full range of operations from peace to war.

FY 2004 End Strength:

Military personnel: 8,878

Civilian personnel: 487



A U.S. Navy F/A-18F Super Hornet, performs at Air Show on Andrews Air Force Base, Clinton, MD.

SHORE ESTABLISHMENT

Commander, Navy Installations

Mission: To enable and enhance Navy combat power by providing the most effective and efficient shore services and support.

FY 2004 End Strength:

Military personnel: 25,522

Civilian personnel: 26,171

Naval Sea Systems Command

Mission: To keep America's Navy #1 in the world by providing the Navy operationally superior and affordable ships, systems, and ordnance throughout their lifecycle...for today, tomorrow, and the Navy after next.

FY 2004 End Strength:

Military personnel: 2,063

Civilian personnel: 36,125

Naval Air Systems Command

Mission: To provide sustainment (current readiness), systems acquisition (future readiness), decision support; and to make the Navy more capable, ready, and affordable in a joint environment.

FY 2004 End Strength:

Military personnel: 2,669

Civilian personnel: 24,718

Space and Naval Warfare Systems Command

Mission: To provide the warfighter with knowledge superiority by developing, delivering, and maintaining effective, capable and integrated command, control, communications, computer, intelligence and surveillance systems.

FY 2004 End Strength:

Military personnel: 484

Civilian personnel: 7,188

Naval Facilities Engineering Command

Mission: To manage the planning, design, construction, contingency engineering, real estate, environmental, and public works support for U. S. Navy shore facilities around the world; to provide the Navy's forces with the operating, expeditionary, support and training bases they need.

FY 2004 End Strength:

Military personnel: 633

Civilian personnel: 13,930

Naval Supply Systems Command

Mission: To provide Navy, Marine Corps, Joint and Allied Forces quality supplies and services on a timely basis with "One Touch Supply."

FY 2004 End Strength:

Military personnel: 446

Civilian personnel: 7,661

Strategic Systems Programs

Mission: To serve our nation by providing credible and affordable sea-based deterrent missile systems.

FY 2004 End Strength:

Military personnel: 457

Civilian personnel: 774

Bureau of Medicine and Surgery

Mission: To provide a comprehensive healthcare delivery system of shore-based treatment facilities and operating forces of the Navy and Marine Corps; and ensure the provision of medical and dental care and services for Navy and Marine Corps personnel, other uniformed services personnel, and eligible beneficiaries authorized by law or regulation.

FY 2004 End Strength:

Military personnel: 31,272

Civilian personnel: 11,402

Navy Personnel Command

Mission: To support the needs of the Navy by providing the Fleet with the right person in the right place at the right time; to satisfy our Sailors' personal goals and improve their quality of life by providing them with meaningful and rewarding career opportunities; to promote and retain the best; and to ensure fair and equitable treatment of all hands, by all hands, at all times.

FY 2004 End Strength:

Military personnel: 10,047

Civilian personnel: 1,466

Naval Education and Training Command

Mission: To educate and train those who serve, providing the tools and opportunities which enable life-long learning, professional and personal growth and development, ensuring fleet readiness and mission accomplishment; to perform such other functions and tasks assigned by higher authority; and to serve as the sole command for individual training and education, and as the Principal Advisor to the Chief of Naval Operations and the Commander, U.S. Fleet Forces Command on training and education related matters.

FY 2004 End Strength:

Military personnel: 16,457

Civilian personnel: 4,287

Naval Security Group Command

Mission: To exploit, defend and attack information for our naval forces and nation.

FY 2004 End Strength:

Military personnel: 6,979

Civilian personnel: 514

Office of Naval Intelligence

Mission: To provide national-level maritime intelligence support to our customers including the joint warfighters, the Department of the Navy, national decision-makers, joint operational commanders, shore-based and theater tactical elements of the Navy and Marine Corps, and foreign partners; to support the acquisition process through scientific and technical analysis of naval weapons systems; and to support nontraditional maritime intelligence missions.

FY 2004 End Strength:

Military personnel: 948

Civilian personnel: 1,194

Field Support Activity

(Field Support Activity provides direct support to the Chief of Naval Operations.)

Mission: To initiate action in matters pertaining to the provision of funds, manpower, and facilities to assigned unified commands, Navy headquarters and activities; and to evaluate the utilization of such resources and initiate or recommend appropriate corrective action.

FY 2004 End Strength:

Military personnel: 11,145

Civilian personnel: 2,923

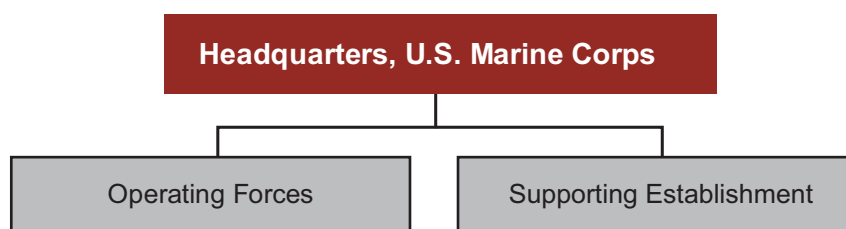
MARINE CORPS ORGANIZATION

Mission: To provide Fleet Marine Forces with combined arms capabilities, including integrated aviation and logistical elements, for service as part of a naval expeditionary force.

FY 2004 End Strength:

Military personnel: 177,480

Civilian personnel: 17,028



Airman signals a CH-53D Sea Stallion preparing to land aboard the amphibious assault ship USS TARAWA (LHA 1),, which was one of many U.S. ships participating in exercise Rim of the Pacific (RIMPAC) 2004.

FY 2004 OVERVIEW OF PERFORMANCE

Implementation of the DON Financial Improvement Plan and the Under Secretary of Defense (Comptroller) (USD(C)) Financial Improvement Initiative has driven progress in the area of the DON General Fund.

Highlights of our progress in FY 2004 include:

- Completion of assertion process for the Investments line item on the DON General Fund Consolidated Balance Sheet;
- Issuance of Accounts Receivable guidance related to the timely collection of delinquent receivables;
- Development of Accounts Payable Workshops to facilitate implementation of Command-level Accounts Payable strategy; and
- Initiation of actions to produce and distribute consolidated DON General Fund trial balances for each DON Major Command, including Marine Corps.

Our financial performance relative to the FY 2004 DON General Fund Consolidated Balance Sheet and Combined Statement of Budgetary Resources appears below.

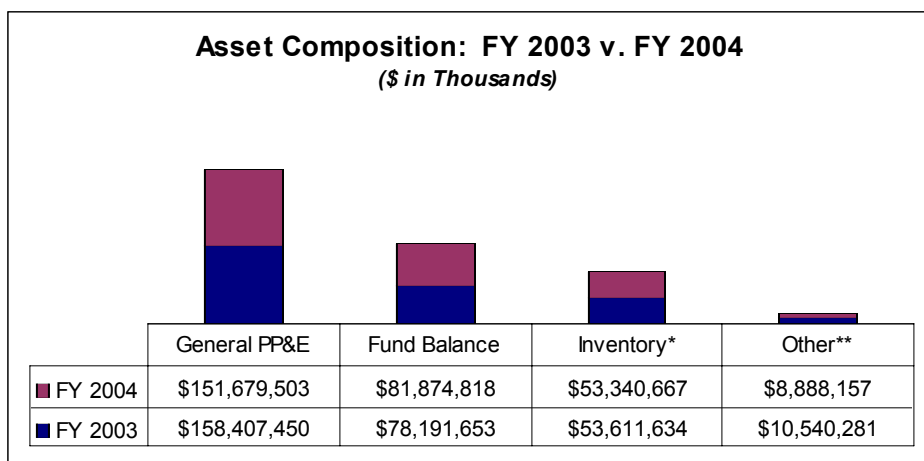
Asset Composition

In FY 2004, Total Assets decreased by two percent. The overall decrease in Total Assets is primarily attributed to Intragovernmental Accounts Receivable. Specifically, DON reported a decrease of \$246,160 thousand (or, 50 percent) in Intragovernmental Accounts Receivables in FY 2004 when compared to FY 2003. This decrease is a result of implementing the Under Secretary of Defense (Comptroller) memo of June 20, 2003, that directed the military departments to establish a goal to close out or collect all over-aged receivables by December 31, 2003. In addition, the trading partner/elimination process with other Federal agencies and DoD organizations contributed to this decrease. Similarly, DON reported a 14 percent decrease in Non-Federal Accounts Receivable. The majority of this decrease is attributed to decreases within the Operation and Maintenance, Navy and Military Personnel, Navy appropriations. (See DON General Fund Notes to the Principal Statements, Note 5, for more information.)

Other significant changes in line items comprising Total Assets are as follows:

Other Assets. DON reported a 45 percent increase in Intragovernmental Other Assets, and a 19 percent decrease in Non-Federal Other Assets in FY 2004. The increase in the intragovernmental balance is attributed to the trading partner/elimination process. The decrease in the non-federal balance is attributed to outstanding contract financing payments within the Aircraft Procurement Program. (See DON General Fund Notes to the Principal Statements, Note 6, for more information.)

Cash and Other Monetary Assets. DON reported a 17 percent decrease in this line item for FY 2004. This decrease is a result of the draw down related to Operation Iraqi Freedom and subsequent events. (See DON General Fund Notes to the Principal Statements, Note 7, for more information.)



**includes operating materials and supplies, held for use*

***comprised of investments, accounts receivable, other assets, and cash and other monetary assets*

Accounts Receivable Metric

As part of the Under Secretary of Defense (Comptroller) (USD(C)) Financial Indicators Program, DON must track the total amount of delinquent Intragovernmental and Public Accounts Receivable. Accounts Receivable is deemed "delinquent" when payment has not been received within 30 days of the date specified in the initial demand letter (Department of Defense Financial Management Regulation, Volume 4, Chapter 3, paragraph 030205). The purpose of the metric is to ensure proper stewardship over public funds and cash management.

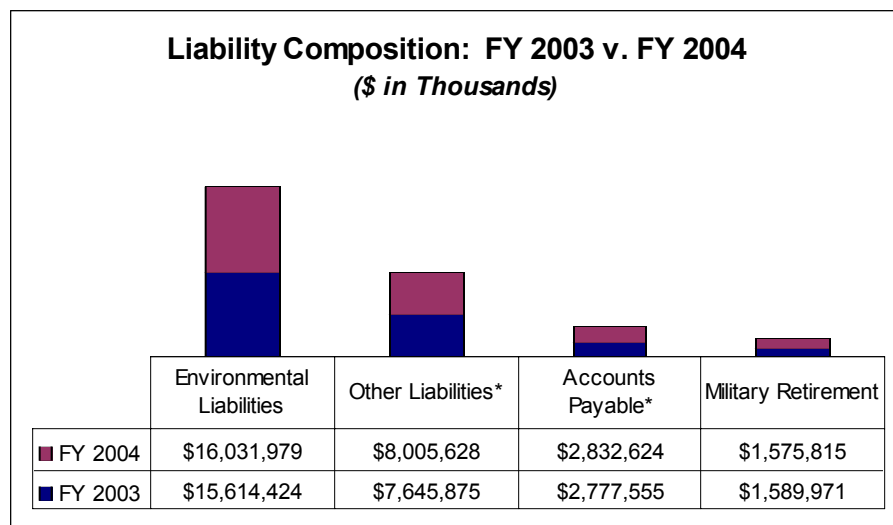
USD(C) has established a Department of Defense-wide goal of 25 percent reduction against the total amount of delinquent Intragovernmental and Public Accounts Receivable. For FY 2004, DON achieved this goal.



A U.S. Marine Corps MV-22 Osprey lands aboard the amphibious assault ship USS BATAAN (LHD 5).

Liability Composition

In FY 2004, Total Liabilities increased by three percent. The overall increase in Total Liabilities is attributed to Intragovernmental Accounts Payable. Specifically, DON reported an increase of \$402,583 thousand (or, 39 percent) in FY 2004 when compared with FY 2003. The increase is the result of the varying needs and execution requirements of DON as well as the trading partner/intragovernmental elimination process. Additionally, DON reported a 20 percent decrease in Non-Federal Accounts Payable in FY 2004. This decrease is attributed to DON business process and policy changes. (See DON General Fund Notes to the Principal Statements, Note 12, for more information.)



**includes intragovernmental debt*

Budgetary Resources, Obligations, and Outlays

In FY 2004, DON reported the following on the DON General Fund Combined Statement of Budgetary Resources:

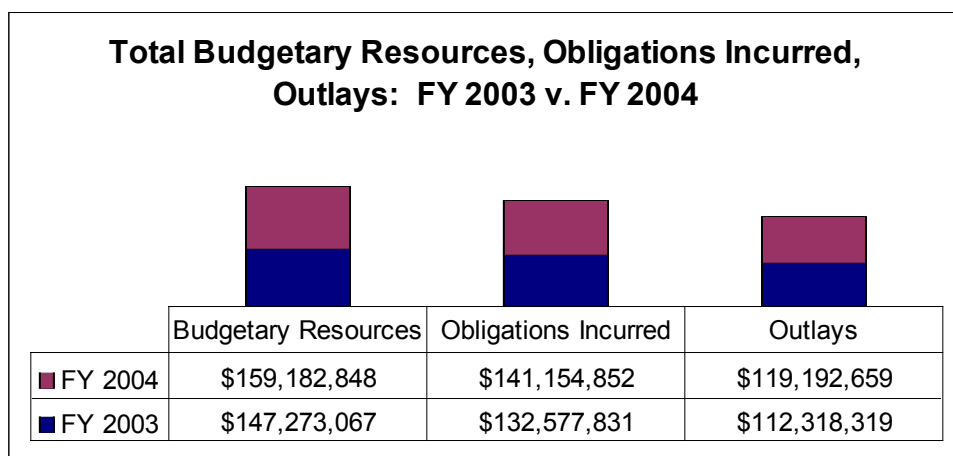
- \$159,183 million, Total Budgetary Resources,
- \$141,155 million, Total Obligations Incurred, and
- \$119,193 million, Total Outlays.

A discussion of these reported budgetary amounts appears below.

Total Budgetary Resources. A primary component of budgetary resources is budget authority (i.e., authority provided by law to enter into financial obligations that will result in immediate or future outlays involving federal government funds). In FY 2004, DON reported \$124,374 million in budget authority (or 78 percent of Total Budgetary Resources). FY 2004 budget authority represents an increase (i.e., less than one percent) from FY 2003 due to continuing efforts to accomplish overall DON mission. Note that Marine Corps initiated a process improvement to capture prior year recoveries in FY 2004.

Total Obligations Incurred. Obligations incurred represent amounts of orders placed, contracts awarded, services received, and similar transactions during a given period that will require payments during the same or future period. Obligations incurred by DON in FY 2004 (i.e., \$141,155 million) represent an increase of six percent from FY 2003. This increase is primarily the result of increased funding for procurement accounts.

Total Outlays. Outlays occur when a federal agency issues checks, disburses cash, or electronically transfers funds to liquidate an obligation. Outlays also occur when interest on the Treasury debt held by the public accrues; the federal government issues bonds, notes, or other cash-equivalent instruments; or a direct or guaranteed loan is disbursed. Outlays reported by DON in FY 2004 (i.e., \$119,193 million) represent an increase of six percent from FY 2003. This increase is the result of increased funding for procurement and research and development accounts.

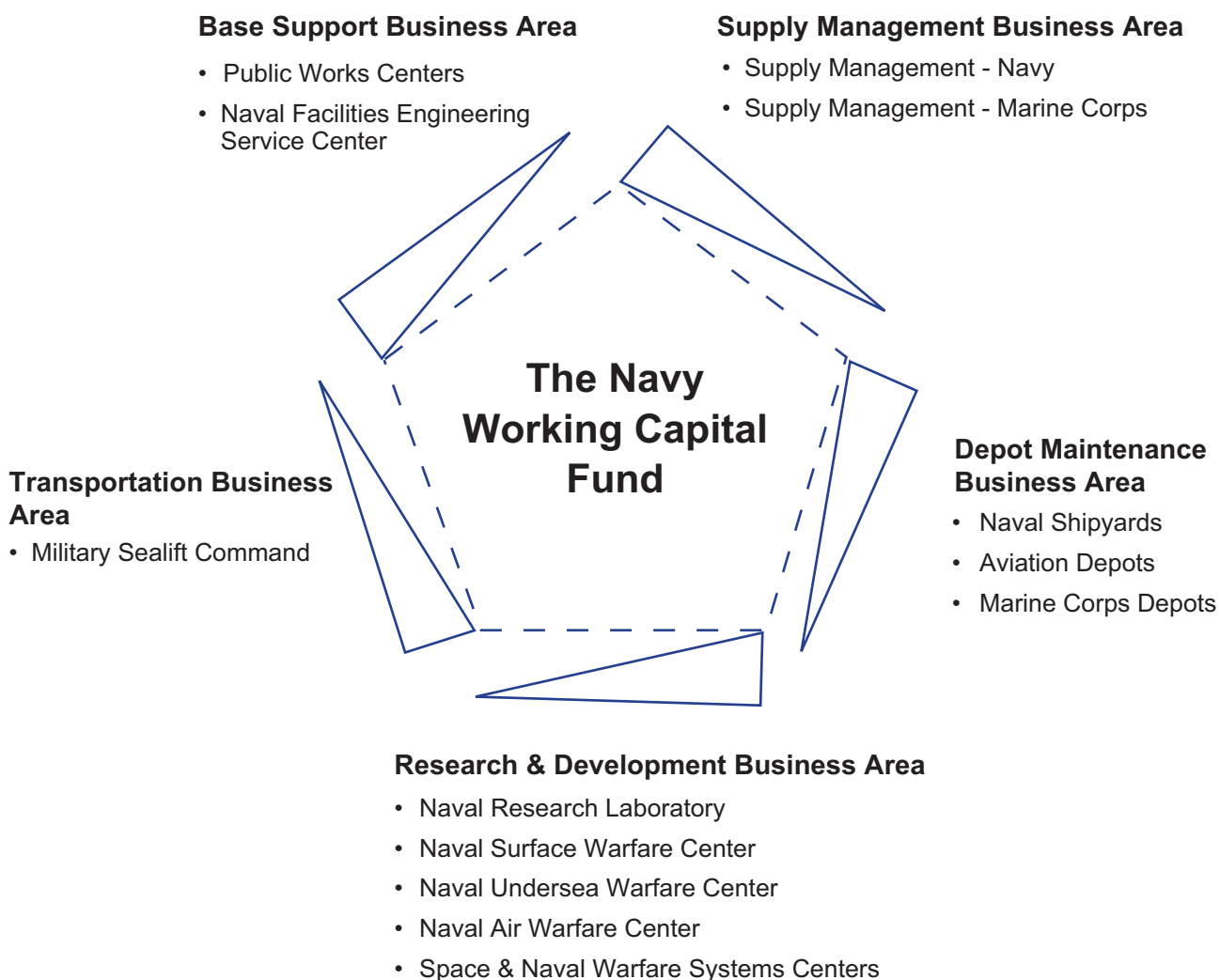


NAVY WORKING CAPITAL FUND

The Navy Working Capital Fund (NWCF) is a revolving fund established to meet the diverse requirements of the Navy and Marine Corps operating forces. Under the revolving fund concept, an appropriation or transfer of funds finances the initial cost of goods and services. Reimbursements from a customer's appropriated account replenish the initial working capital and permit continuing operations without further appropriation by Congress. Unlike profit-oriented businesses, the goal of the revolving fund is to break even over time.

NWCF BUSINESS AREAS

Included in the NWCF are five business areas comprised of one or more activities. NWCF activities stabilize the price of goods and services in their budget to protect customers from unforeseen fluctuations. Each NWCF activity is comprised of civilian and/or military personnel and has a defined mission that supports the overall Department of the Navy mission.



Supply Management

The Supply Management business area consists of Navy and Marine Corps components, which operate under the purview of their respective Commands: Naval Supply Systems Command and Marine Corps Logistics Command. In FY 2004, total actual end strength (i.e., civilian and military personnel) for the Supply Management business area was 6,430. However, Supply Management-Navy anticipates end strength to change in FY 2005 and FY 2006, as a result of planned strategic sourcing efforts at the Fleet and Industrial Supply Centers, the Naval Supply Information Systems Activity, and the Naval Inventory Control Point. Similarly, Supply Management-Marine Corps expects end strength to decrease in FY 2005.

SUPPLY MANAGEMENT, NAVY

Mission: To provide Navy, Marine Corps, Joint and Allied Forces quality supplies and services on a timely basis with "One Touch Supply."

SUPPLY MANAGEMENT, MARINE CORPS

Mission: To perform inventory management functions that result in sale of consumable and reparable items to support both the Department of Defense and other government agencies.

Depot Maintenance

The Depot Maintenance business area consists of Naval Shipyards, Aviation Depots, and Marine Corps Depots, all of which operate under the purview of their respective commands: Naval Sea Systems Command, Naval Air Systems Command, and Marine Corps Logistics Command. In FY 2004, total actual end strength (i.e., civilian and military personnel) for the Depot Maintenance business area was 24,558. (See chart for actual FY 2004 end strength by activity groups.)

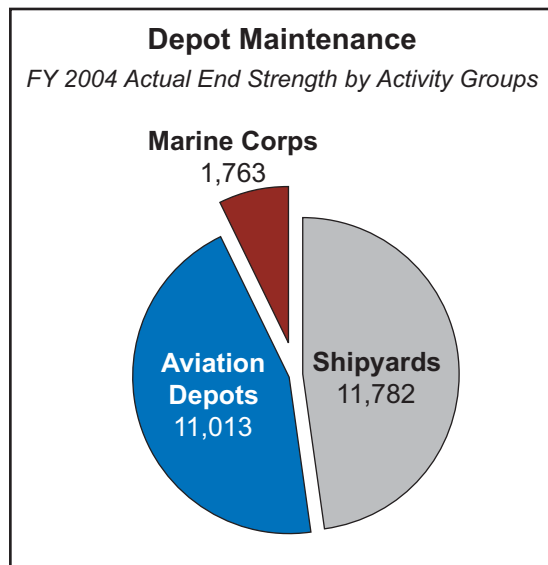
In subsequent fiscal years, the Depot Maintenance business area anticipates end strength to change. Specifically, Naval Shipyards expect evolving workload requirements and process efficiencies to affect civilian end strength and workyears. Aviation Depots expect civilian end strength and workyears to decrease based on projected use of contractor labor and workload fluctuations. In contrast, Marine Corps Depots anticipate end strength to increase in FY 2005 to accommodate additional workload for repairing combat-damaged equipment and weapons systems used in the Global War on Terrorism. However, based on projected workload for FY 2007, Marine Corps Depots expect to reduce the permanent workforce through voluntary separation incentives and to release the temporary employees hired to support unplanned workload increases in prior fiscal years.

DEPOT MAINTENANCE, SHIPYARDS

Mission: To provide logistics support for assigned ships and service craft; perform authorized work in connection with construction, overhaul, repair, alteration, drydocking and outfitting of ships and craft as assigned; perform design, manufacturing, refit and restoration, research and development and test work, and provide services and material to other activities and units as directed by competent authority.

DEPOT MAINTENANCE, AVIATION

Mission: To provide responsive worldwide maintenance, engineering, and logistics support to the Fleet and ensure a core industrial resource base essential for mobilization; repair aircraft, engines, and components, and manufacture parts and assemblies; provide engineering services in the development of hardware design changes, and furnish technical and other professional services on maintenance and logistics problems.



DEPOT MAINTENANCE, MARINE CORPS

Mission: To provide the quality products and responsive maintenance support services required to maintain a core industrial base in support of mobilization, surge and reconstitution requirements.

Research and Development

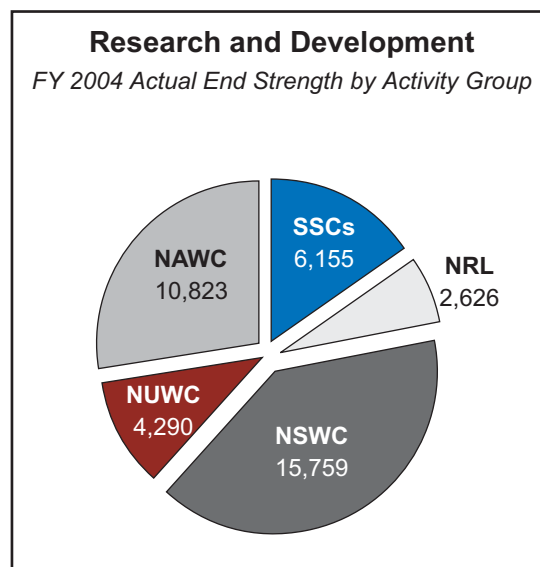
The Research and Development business area consists of the Naval Research Laboratory and four Naval Warfare Centers, all of which operate under the purview of their respective Commands. In FY 2004, total actual end strength (i.e., civilian and military personnel) for the Research and Development business area was 39,653. (See chart for actual FY 2004 end strength by activity group.) To compensate for the projected loss of retired personnel in subsequent fiscal years, the Space and Naval Warfare Systems Centers plan to continue workforce revitalization through recruitment and retention of talented C4ISR (Command, Control, Communications, Computers, Intelligence, Surveillance, and Reconnaissance) professionals.

NAVAL RESEARCH LABORATORY

Mission: To operate the Navy's full spectrum corporate laboratory, conducting a broadly based multidisciplinary program of scientific research and advanced technological development directed toward maritime applications of new and improved materials, techniques, equipment, systems and ocean, atmospheric, and space sciences and related technologies.

NAVAL SURFACE WARFARE CENTER

Mission: To operate the Navy's full spectrum research, development, test and evaluation, engineering and fleet support center for ship hull, mechanical, and electrical systems, surface combat systems, coastal warfare systems, and other offensive and defensive systems associated with surface warfare.



NAVAL UNDERSEA WARFARE CENTER

Mission: To operate the Navy's full spectrum research, development, test and evaluation, engineering and fleet support center for submarines, autonomous underwater systems, and offensive and defensive weapons systems associated with undersea warfare.

NAVAL AIR WARFARE CENTER

Aircraft Division

Mission: To operate the Navy's principal research, development, test and evaluation, engineering, and fleet support activity for naval aircraft engines, avionics, and aircraft support systems and ship/shore/air operations.

Weapons Division

Mission: To operate as the Navy's full spectrum research, development, test and evaluation in-service engineering center for air warfare weapons systems (except anti-submarine warfare systems), missiles and missile subsystems, aircraft weapons integration, and assigned airborne electronic warfare systems; and as the Department of the Navy's air, land, and sea test ranges.

SPACE AND NAVAL WARFARE SYSTEMS CENTERS

Mission: To operate the Navy's full spectrum research, development, test and evaluation, engineering, and fleet support centers for command, control, and communication systems and ocean surveillance and the integration of those systems that overarch multiple platforms.

Transportation

The Transportation business area is comprised of the Military Sealift Command, which has dual reporting responsibilities to DON (as a NWCF activity group), and to the U.S. Transportation Command.

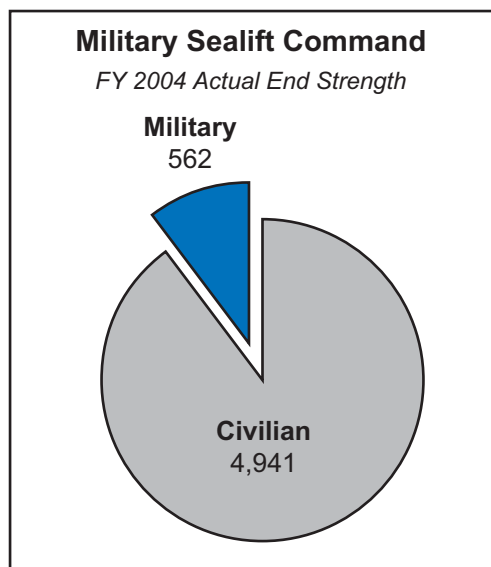
MILITARY SEALIFT COMMAND

Mission: To provide ocean transportation of equipment, fuel, supplies and ammunition to sustain U.S. forces worldwide during peacetime and in war for as long as operational requirements dictate.

The Military Sealift Command supports three separate and distinct ship programs:

- Naval Fleet Auxiliary Force - provides fuel, food, ammunition, spare parts and other supplies, enabling the Navy fleet to operate at the highest possible operating tempo. In July 2004, Naval Fleet Auxiliary Force East merged with Military Sealift Command Atlantic and Combat Logistics Squadron Two to become the Sealift Logistics Command Atlantic.
- Special Mission Ships - provide oceanographic and hydrographic surveys, underwater surveillance, missile flight data collection and tracking, acoustic research and submarine support, and other support for Department of Defense sponsors.
- Afloat Pre-Positioning Force Ships-Navy - provide military equipment and supplies for a contingency forward deployed in key ocean areas before it is needed.

In FY 2004, total actual end strength (i.e., civilian and military personnel) for the Military Sealift Command was 5,503 (see chart). In FY 2006 and FY 2007, the Military Sealift Command expects an increase in afloat civilian/civilian mariner end strength, as a result of additional ships augmenting the Naval Fleet Auxiliary Force.



The guided missile frigate USS JOHN L. HALL (FFG 32) departs for sea in preparation for PANAMAX 2004

Base Support

The Base Support business area consists of eight Public Works Centers and the Naval Facilities Engineering Service Center, which operate under the purview of the Naval Facilities Engineering Command. In FY 2004, Public Works Centers transferred functional support of Navy shore installations to Commander, Navy Installations, and established detachment at various Naval Surface and Naval Air Warfare Centers. Additionally, Public Works Center Pensacola became a detachment of Public Works Center Jacksonville, reducing the total number of centers from nine to eight.

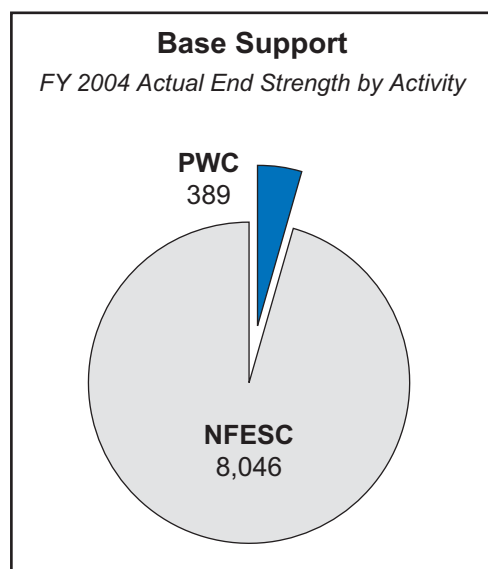
PUBLIC WORKS CENTER

Mission: To provide Navy, tenant Department of Defense, and tenant federal clients with quality public works support and services, including utilities services, facilities maintenance, transportation support, engineering services, environmental services, and shore facilities planning support.

NAVAL FACILITIES ENGINEERING SERVICES CENTER

Mission: To deliver quality products and services in Energy and Utilities, Amphibious and Expeditionary Systems, Environment, Shore, Ocean, and Waterfront Facilities.

In FY 2004, total actual end strength (i.e., civilian and military personnel) for the Base Support business area was 8,435. (See chart for actual FY 2004 end strength by activity.) Public Works Centers anticipate a decrease in civilian end strength and workyears in subsequent fiscal years due to reorganizations, outsourcing, and workload reductions.



The conventional aircraft carrier USS KITTY HAWK (CV 63) combat systems department conducts a Close-In Weapons System (CIWS) pre-action calibration on CIWS Mount 24.

FY 2004 OVERVIEW OF PERFORMANCE

Implementation of the DON Financial Improvement Plan and the Under Secretary of Defense (Comptroller) (USD(C)) Financial Improvement Initiative has begun in the NWCF area. Specifically, the Assistant Secretary of the Navy (Financial Management and Comptroller) plans to initiate the assertion process for NWCF Personal Property, Accounts Receivable, and Debt in the first quarter, FY 2005.

PROGRAM PERFORMANCE

Supply Management

Supply Management, Navy. Since 1998, Supply Management, Navy has used average customer wait time to improve customer support. FY 2004 goals for average customer wait time for aviation and maritime supplies were 7.5 days and 18.8 days, respectively. As of June 30, 2004, Supply Management, Navy remained on track to achieve their fiscal year-end goals: the actual average customer wait time for aviation and maritime supplies was 7.9 days and 19.9 days, respectively.

Supply Management, Marine Corps. The availability of spare parts is an essential performance metric to warfighting customers. Accordingly, the Supply Management business area establishes goals and continuously monitors results so that corrective actions can be taken, when necessary, to maximize performance outputs. In FY 2004, Supply Management, Marine Corps established a goal of 85 percent for supply chain channel performance.

Depot Maintenance

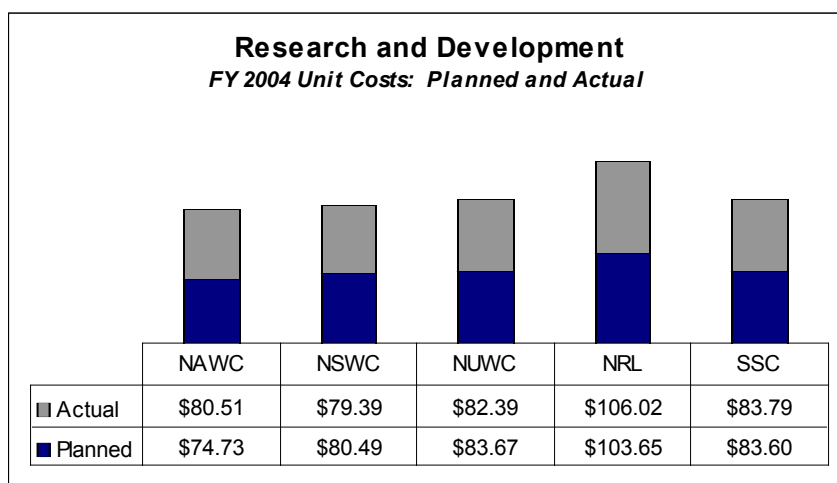
Depot Maintenance, Shipyards. The shipyards remain committed to productivity improvement. One measure of productivity is the direct labor indicator, expressed in part as a percentage of total direct labor man hours and overhead. In FY 2004, shipyards exceeded their direct labor goal of 67.9 percent, reporting an actual result of 68.2 percent of total direct and overhead hours.

Depot Maintenance, Aviation. Aviation depots, such as NAVAIR Depot Jacksonville, continue to focus on business efficiencies. In the third quarter of FY 2004, NAVAIR Depot Jacksonville produced 11,156 components, reducing component physical work-in-process by 21 percent. Additionally, NAVAIR Depot Jacksonville sold F/A-18 Sequence JX40 out of PMI2 seven days ahead of schedule. This particular airframe was converted to the Blue Angel configuration.

Depot Maintenance, Marine Corps. Schedule conformance improved in FY 2004 as the workforce positioned for the workload influx associated with the Global War on Terrorism. Depot Maintenance, Marine Corps advanced toward their 100 percent goal through management initiatives aimed at increasing and improving productivity yield through continued implementation of the Theory of Constraints. Similarly, Marine Corps maintenance centers remained focused on refining and expanding implementation of the Theory of Constraints and the application of Lean Thinking to eliminate inefficiencies in shop-level procedures.

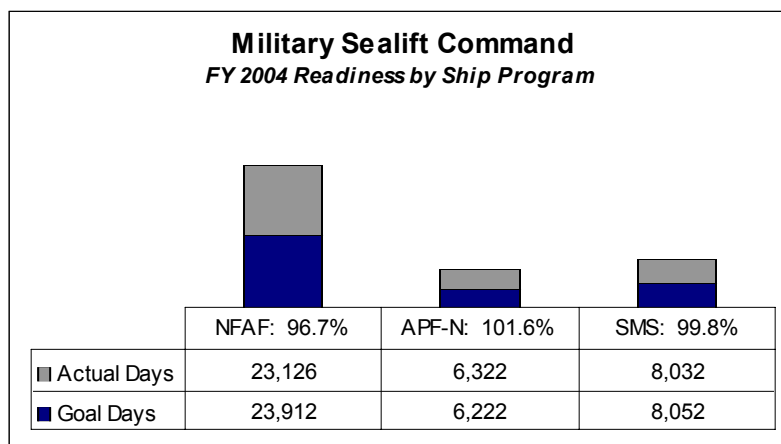
Research and Development

The span of Research and Development (R&D) activities' products and services is broad and diverse. The primary measure of performance for the R&D activities is cost per direct labor hour, calculated as direct labor (civilian and military labor plus overhead) divided by direct labor hours. This financial indicator measures cost effectiveness in mission performance. The chart below presents FY 2004 planned and actual cost per direct labor hour for each R&D activity.



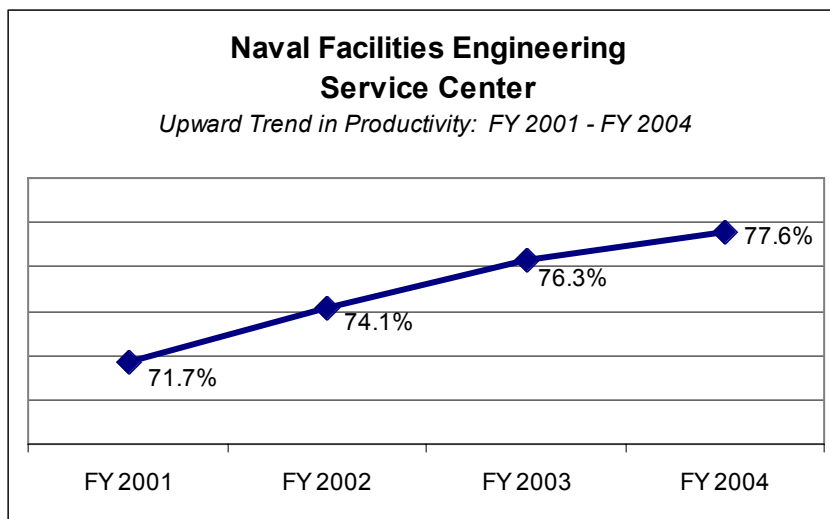
Transportation

To ensure mobility of combat-ready naval forces, it is critical that the Military Sealift Command meet its readiness goals. The Military Sealift Command bases readiness on "goal days," calculated as the number of days ships are available to perform a mission multiplied by the number of ships in the program. In FY 2004, the Military Sealift Command exceeded 100 percent readiness in the Afloat Pre-positioning Force Ships-Navy (APF- N) Program (see chart). This achievement is attributed primarily to the activation of the USNS CAPE JOHN (T-AK 5022) and USNS CAPE GIBSON (T-AK 5051) Ready Reserve Force ships during the first quarter of FY 2004. In the Special Mission Ships (SMS) Program, the Military Sealift Command achieved 99.8 percent readiness due in part to an unplanned deactivation of the USNS CAPABLE (T-AGOS 16) in September 2004. In their Naval Fleet Auxiliary Force (NFAF) Program, the Military Sealift Command achieved 96.7 percent readiness, reflecting the workload decrease for Harbor Tugs operating in Norfolk and San Diego and the delayed activation of the USNS BRIDGE (T-AOE 10).



Base Support

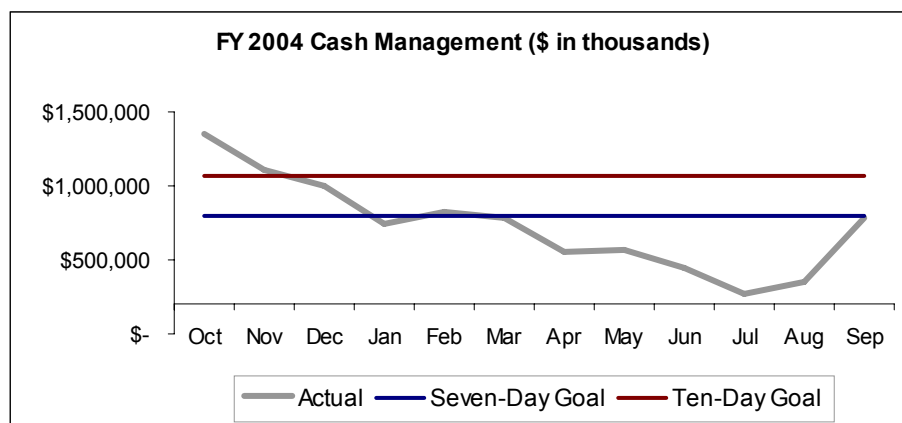
As their workload increases, and manual processes are automated, Naval Facilities Engineering Services Center continues an upward trend in productivity in FY 2004 (see chart).



FINANCIAL PERFORMANCE

Cash Management

Working Capital Fund cash is managed at the Departmental level. The Department of Defense Financial Management Regulation requires Working Capital Fund cash levels be maintained at seven to ten days of operational costs, and be sufficient to meet six months of capital outlays. For FY 2004, the seven-day cash requirement was \$792 million and the ten-day requirement was \$1,063 million (see chart below). Based on the relatively large beginning balance of \$1,827 million, DON structured its FY 2004 budget with a disbursement of \$448 million from NWCF cash to the Operation and Maintenance, Navy appropriation. Early in the fiscal year, Congress and the Office of the Secretary of Defense authorized additional transfers of \$88 million. These transfers, along with anticipated outlays in the Supply Management Business Area, resulted in a projected year-end balance of \$901 million. During FY 2004, actual cash levels tracked closely with the projected plan except for an unanticipated transfer of \$200 million directed by the Department of Defense in June 2004 to help finance the Global War on Terrorism. This last transfer is the primary reason the actual cash balance finished approximately \$223 million below the projected level of \$901 million.



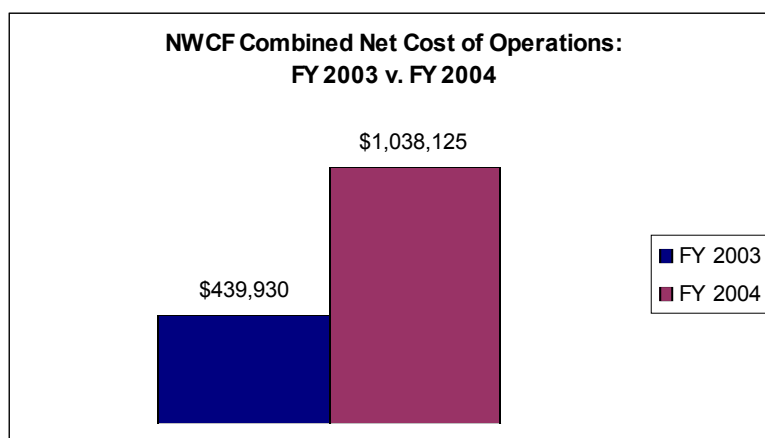
Net Cost of Operations

The NWCF Consolidating Statement of Net Cost present earned revenue and program costs by business area. The total net cost presented is calculated as the sum of:

- Intragovernmental Net Costs (i.e., intragovernmental gross costs less intragovernmental earned revenue), and
- Net Costs With the Public (i.e., gross costs with the public less revenue with the public).

NWCF net cost of operations is based on the combined total net cost for the business areas, or "Total Net Program Costs," after adjustments for any costs not assigned to programs or earned revenue not attributable to programs. In FY 2003 and FY 2004, there were no adjustments required for costs not assigned to programs and earned revenue.

In FY 2004, the combined total net cost for the NWCF business areas - Supply Management, Depot Maintenance, Research and Development, Transportation, Base Support - NWCF ordnance and component level was \$1,038,125 thousand.



Note: Totals above also include net cost of operations for NWCF ordnance and component level.



The Nimitz-class aircraft carrier USS JOHN C. STENNIS (CVN 74).

NET COST OF OPERATIONS BY NWCF BUSINESS AREA

NWCF Business Area	FY 2004 \$ (000)	FY 2003 \$ (000)
Supply Management		
Program Costs	\$ 6,870,512	\$ 8,456,945
Less: Earned Revenue	6,106,967	6,895,749
Net Cost of Operations	\$ 763,545	\$ 1,561,196
Depot Maintenance		
Program Costs	\$ 1,942,893	\$ 5,192,971
Less: Earned Revenue	4,788,820	5,346,593
Net Cost of Operations	\$ (2,845,927)	\$ (153,622)
Research and Development		
Program Costs	\$ 10,296,517	\$ 9,573,205
Less: Earned Revenue	10,259,846	9,585,868
Net Cost of Operations	\$ 36,671	\$ (12,663)
Transportation		
Program Costs	\$ 1,777,196	\$ 1,789,147
Less: Earned Revenue	1,792,429	1,844,089
Net Cost of Operations	\$ (15,233)	\$ (54,942)
Base Support		
Program Costs	\$ 1,581,392	\$ 1,569,729
Less: Earned Revenue	1,602,991	1,584,722
Net Cost of Operations	\$ (21,599)	\$ (14,993)



An F-18C Hornet from Fighter Attack Squadron Three Seven

CONCLUSION

The financial statements have been prepared to report the financial position and results of operations for the entity, pursuant to the requirements of Title 31, United States Code, Section 3515(b).

The statements have been prepared from the books and records of the entity, in accordance with the formats prescribed by the Office of Management and Budget. These statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

To the extent possible, the financial statements have been prepared in accordance with federal accounting standards. At times, the Department is unable to implement all elements of the standards due to financial management systems limitations. The Department continues to implement system improvements to address these limitations. There are other instances when the Department's application of the accounting standards is different from the auditor's application of the standards. In those situations, the Department has reviewed the intent of the standard and applied it in a manner that management believes fulfills that intent.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that the liabilities cannot be liquidated without legislation that provides resources to do so.



USNS CAMDEN (T-AOE 2) prepares to receive USS NIMITZ (CVN 68) alongside for a replenishment at sea.



Sailors man the rails aboard the Navy's newest and most advanced Arleigh Burke-class guided missile destroyer USS CHUNG-HOON (DDG 93).